Research and Development Expenses Tax Credit Guidelines

Introduction

These guidelines are published by the Department of Taxation (the "Department") to provide guidance to taxpayers regarding the Virginia Research and Development Expenses Tax Credit as provided in *Va. Code* § 58.1-439.12:08. Pursuant to House Bill 1447 (*Acts of Assembly 2011*, Chapter 742), and Senate Bill 1326, (*Acts of Assembly 2011*, Chapter 745), signed by Governor Robert F. McDonnell on March 28, 2011, the development and publication of these guidelines is exempt from the provisions of the Administrative Process Act (§ 2.2-4000 *et seq*.) of the *Code of Virginia*.

The Department has worked with representatives for affected research and development companies and other interested parties to develop these guidelines. As necessary, additional information will be published and posted on the Department's website, at www.tax.virginia.gov/.

Definitions

Terms used throughout the Research and Development Expenses Tax Credit guidelines have the same meaning as those used for Corporate or Individual Income Tax, unless defined otherwise, as follows:

"Virginia base amount" has the same meaning as provided in *Va. Code* § 58.1-439.12:08.

"Virginia gross receipts" has the same meaning as provided in *Va. Code* § 58.1-439.12:08.

"Virginia qualified research" has the same meaning as provided in *Va. Code* § 58.1-439.12:08.

"Virginia qualified research and development expenses" has the same meaning as provided in *Va. Code* § 58.1-439.12:08.

General Overview

Under *Va. Code* § 58.1-439.12:08, an individual, corporation or pass-through entity that conducts research and development activities in Virginia is allowed a refundable individual or corporate income tax credit for the amount of research and development expenses that exceed the taxpayer's Virginia base amount. The tax credit is allowed in the taxable year for which the expenses are reported on the federal income tax return, in accordance with the taxpayer's accounting method. The research and development expenses tax credit is comprised of a base tax credit amount and a supplemental tax credit that is allocated when the total amount of credits granted for each fiscal year is less than the $5 million limitation.

Research and Development Expenses Tax Credit

Tax Credit Amount

The tax credit is equal to: (i) 15 percent of the first $167,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year, or (ii) 20 percent of the first $175,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year if the Virginia qualified research was conducted in conjunction with a Virginia public or private college or university.

If the total eligible credit requests exceed the $5 million annual fiscal limitation, each taxpayer will be granted a pro rata amount as determined by the Department. The amount of the prorated credit will be determined by multiplying a fraction, the numerator of which is the credit requested by the eligible taxpayer for such year, and the denominator of which is the total credits requested by all eligible taxpayers for such taxable year, by the annual fiscal limitation of $5 million.

Supplemental Tax Credit Amount

If the total amount of approved tax credits for all applications for any taxable year is less than the $5 million limitation, the Department will allocate credits up to the maximum of $5 million, on a pro rata basis, to taxpayers who are already approved for the tax credit. This supplemental allocation of tax credits for the taxable year is equal to: (i) 15 percent of the second $167,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year, or (ii) 20 percent of the second $175,000 in Virginia qualified research and development expenses paid or incurred by the taxpayer during the taxable year if the research and development is conducted in conjunction with a Virginia public or private college or university.

Refundable Tax Credit

The research and development expenses tax credit is refundable. Therefore, if the amount of the credit that a taxpayer is allowed exceeds the taxpayer's tax liability for the taxable year, then the amount that exceeds the tax liability will be refunded to the taxpayer. A refund of the amount of the credit that exceeds the taxpayer’s tax liability, however, will be subject to certain limitations as set forth in these guidelines.

<u>Computation of the Tax Credit</u>

The research and development expenses tax credit is based on the amount of research and development expenses that exceed those expenses that a taxpayer normally pays or incurs for research and development conducted in Virginia (i.e., the “Virginia base amount”). The computation of the tax credit is based on the number of taxable years that a taxpayer has conducted research and development activities in Virginia. The procedure for calculating the tax credit amount is derived from the federal procedure for calculating the federal research and development tax credit. The computation of the Virginia research and development expenses tax credit is as follows:

Research and Development Expenses Tax Credit

1. Determine the Virginia qualified research expenses for the credit year.
2. Determine Fixed Base Percentage:
   a. Determine the average amount of Virginia qualified research and development expenses for the three taxable years preceding the year in which the tax credit is being claimed. If the taxpayer has only been in business for less than three years, but at least one, use the number of years in business instead of three.
   b. Determine the total gross receipts for the three taxable years preceding the taxable year that the tax credit is being claimed, or the number of years used for step 2, if less.
   c. Calculate the percentage of Virginia qualified research and development expenses by dividing the average amount determined in step 2 by the average amount determined in step 3. This is the "fixed base percentage."
3. Determine the Virginia Base Amount:
   a. Determine average of the total gross receipts for the four taxable years preceding the taxable year that the tax credit is being claimed, or the number of years used for step 2, if less.
   b. Multiply the fixed base percentage in step 2 by the average gross receipts in step 3a.
   c. The Virginia base amount is the greater of the amount in step 3a or 50% of the amount in step 1.
4. From the amount of Virginia qualified research expenses in step 1, determine the amount that is for qualified research conducted in conjunction with a public or private college or university located in Virginia.
5. From the amount of Virginia qualified research expenses in step 1, subtract the Virginia base amount computed in step 3.
   a. If less than zero, stop. There are no expenses that qualify for the credit.
   b. If greater than zero, proceed to compute the credit.
6. The credit is the greater of:
   a. 15% times the lesser of (i) the amount computed in step 5, or (ii) $167,000; or
   b. 20% times the lesser of (i) the amount determined in step 4, (ii) the amount determined in step 5, or (iii) $175,000.

Example 1. A taxpayer had $750,000 in Virginia qualified expenses in 2011, of which $150,000 was for research conducted in conjunction with a Virginia university. The taxpayer's average Virginia qualified research and development expenses for the three taxable years immediately preceding the taxable year that the expense is incurred are: $450,000 in 2008; $500,000 in 2009; and $550,000 in 2010. The taxpayer's total gross receipts for the preceding four taxable years are: $10 million in 2007, $12 million in 2008, $14 million in 2009, and $16 million in 2010.

The Fixed Base Percentage is 3.57%, computed as follows:

> [($450,000 + $500,000 + $550,000) / 3] / [($12 mil. + $14 mil. + $16 mil.) /3].

The Virginia Base Amount is $464,100, computed as follows:

> 3.57% * [($10 mil. + $12 mil. + $14 mil. + 16 mil.) / 4], which is greater than 50% of $750,000.

Therefore, the credit is $30,000, computed as follows:

> 15% of the lesser of $285,900 ($750,000 – $464,100) or $167,000 = $25,050; or
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> 20% of the lesser of $150,000, $285,900, or $175,000 = $30,000.

Supplemental Tax Credit

In the event that the total amount of tax credits approved by the Department is less than the $5 million limitation, the Department will calculate the supplemental tax credit amount for each taxpayer and allocate the credits accordingly.

Corporate Restructuring

When determining the Virginia base amount, the taxpayer must include any Virginia qualified research and development expenses and gross receipts from an acquired, consolidated, merged or restructured entity. Thus, if a company purchases another company during the taxable year that the expenses are paid or incurred, then the purchasing company is allowed to include the acquired company's Virginia qualified research and development expenses in the computation of the tax credit. However, the purchasing company must also include the acquired company's research and development expenses in the relevant previous years when determining the Virginia base amount.

When a taxpayer undergoes corporate restructuring in which an affiliate is sold, then the taxpayer can only include the portion of Virginia qualified research and development expenses and gross receipts attributable to the affiliate for the portion of the credit year and relevant preceding years that the taxpayer owned the affiliate.

<u>Requirements</u>

Research and Development must meet the federal definition for research activities.

Under IRC § 41(d), research and development involves a systematic study or search directed toward discovering new information that is scientific or technical, and is used for the development of a new or improved product or process. Research and development must have as its ultimate purpose: (i) the development of a new or improved product or process; (ii) improving the performance of an existing product or process; or (iii) improving the quality or reliability of a new or existing product or process.

Research and development generally does not include the following activities:

- adaptation of an existing product or process merely to meet customer specifications (except if the adaptation is carried out under experimental or laboratory conditions in order to improve the product or process or to develop a new use for the product or process);

- duplication of an existing business activity;

- surveys, studies or routine activities, including: testing or inspection of materials or products for quality control; environmental analysis; testing of samples for chemical or other content; operations research; feasibility studies; efficiency surveys; management studies; consumer surveys; economic surveys; research in the social sciences; market research including advertising and promotions; and routine data collection;

- development of computer software for internal use (except if the software development contributes to Virginia qualified research and development); or

- any research and development that is already funded by a grant, contract or another entity, including a government entity.

Virginia research and development expenses must meet the federal definition for qualified research in order to qualify.

Virginia research and development expenses must meet the federal definition for qualified research expenses under IRC § 41(b), as amended, in order to qualify for the tax credit. Under IRC § 41(b), qualified research expenses include "in-house expenses," which consists of the following: (i) wages, as defined in IRC § 3401(a) or 401(c)(1) paid or incurred to an employee, except for wages used to determine the federal work opportunity credit under IRC § 51(a); (ii) amounts paid or incurred for supplies, as defined in IRC § 41(b)(2)(C), except for land or land improvements and property that is subject to depreciation, that are used in research and development; and (iii) amounts paid or incurred to another person or business for the right to use computers.

Under IRC § 41(b), qualified research expenses also includes "contract research expenses," which consists of the following: (i) 65 percent of any amount paid or incurred by a taxpayer to a person for qualified research; (ii) 75 percent of any amount paid or incurred by a taxpayer to a qualified research consortium; (iii) amounts paid or incurred to small businesses within the meaning of IRC § 318; (iv) amounts paid or incurred to universities as defined in IRC § 3304(f); and (v) amounts paid or incurred to federal laboratories.

Research and Development must be conducted in Virginia.

A taxpayer applying for a tax credit for qualified Virginia research and development expenses must ensure that its research and development activities are conducted within Virginia. Research and development is conducted in Virginia to the extent that it is conducted at a research laboratory, office, plant, or other facility located in Virginia, regardless of whether the organization conducting the research is organized under the laws of Virginia or another jurisdiction, where supplies and resources are used in research and development activities are consumed. Where research and development is conducted jointly at research facilities located within and outside of Virginia, the research and development expenses include only the payments attributable to the portion of the qualified research and development conducted within Virginia. If a taxpayer includes the wages of individuals that conduct research and development as part of its expenses, then the employees must conduct research and development in Virginia.

> **Example 2.** Taxpayer A is a business organized under the laws of State A, but contracts with a business located within Virginia to conduct research and development. The expenses for research and development activities would qualify for the Virginia research and development expenses tax credit. If the research and development activities are conducted in State A and Virginia, then Taxpayer A can only claim a credit for those expenses paid or incurred for research and development activities conducted from within Virginia.

Taxpayers that conduct research and development in conjunction with a Virginia public or private college or university must satisfy certain criteria.

A taxpayer that conducts qualified Virginia research and development in conjunction with a college or university may qualify for the increased tax credit, provided the college or university is a Virginia public or private college or university. In order to verify that it is a Virginia public or private college or university, the Department will rely on a list of Virginia public and private colleges and universities provided by the State Council for Higher Education for Virginia.

The public or private college or university must satisfy the following basic standards: (i) admit students that have a certificate of graduation, or equivalent, from a high school; (ii) be legally authorized to provide a program of education beyond high school; and (iii) award a bachelor's degree or a higher degree, or provide a program which is acceptable for full credit toward a bachelor's degree. (Source: IRC § 3304(f))

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Under IRC § 41(b), qualified research expenses include expenses paid or incurred for contracting a college or university to conduct qualified research. A taxpayer that paid or incurred expenses for conducting research and development in Virginia in conjunction with a college or university from another state can earn a Virginia tax credit equal to 15 percent of the first $167,000 in Virginia qualified research and development expenses, provided that the research is conducted at the taxpayer's facility in Virginia. In order to earn the increased Virginia tax credit (20 percent of the first $175,000 in Virginia qualified research and development expenses), the institution must be a Virginia public or private college or university.

If a taxpayer has contracted with a public or provide college or university in Virginia that conducts research and development in multiple states, only the expenses from research and development conducted in Virginia will qualify for the tax credit.

A taxpayer applying for a tax credit for qualified Virginia research and development conducted in conjunction with a Virginia public or private college or university must be able to provide evidence of contracting with the academic institution. Evidence of contracting with a Virginia public or private college or university includes a formal agreement that outlines the type of research and development to be conducted and is signed by the taxpayer, or an authorized officer of the taxpayer, and a qualified person from the academic institution. There must also be evidence of payments made or incurred by the taxpayer to the academic institution. A taxpayer should consult a Virginia college or university about its contracting policies and processes.

Any taxpayer that conducts research and development in conjunction with an individual researcher, professor or student researcher that has received grant funding or funding from other sources will not earn the tax credit.

Research and Development expenses must not be used as the basis for another Virginia credit.

The expenses used for determining the tax credit for Virginia qualified research and development expenses must not be used as the basis for claiming any other credit provided under the Code of Virginia. A taxpayer, however, will be allowed to use the same expenses for claiming the Virginia research and development expenses tax credit that are used in determining the federal tax credit for research activities under IRC § 41.

In order for the tax credit to be refundable, the research cannot be conducted on embryonic stem cells or human tissues from induced abortions.

A taxpayer that engages in research and development in Virginia that involves research conducted on human embryonic stem cells, tissues derived from induced abortions, or other human tissue, will not be allowed to claim the tax credit. However, a taxpayer that conducts research using stem cells other than human embryonic stem cells will be allowed to claim the refundable tax credit.

Research and Development Expenses Tax Credit

A taxpayer that does not engage in research and development in Virginia that involves research conducted on human embryonic stem cells, tissues derived from induced abortions, or other human tissue, but does engage in such research and development in another state, will only be allowed a non-refundable tax credit. For such nonrefundable credits, there is no provision under *Va. Code* § 58.1-439.12:08 that allows a carryover if the credit amount exceeds a taxpayer's tax liability.

Documentation and Record Keeping

A taxpayer must provide documentation that outlines the type of research and development conducted in Virginia and substantiates the calculation of the Virginia research and development expenses tax credit, including the Virginia fixed-base percentage and the average annual gross receipts. Further, a taxpayer that is headquartered outside of Virginia, but has employees in Virginia or contracts with an entity conducting research and development in Virginia, must provide documentation regarding where the research and development was conducted, how much time was spent conducting the research and development and the type of research and development that was conducted.

Any documentation that demonstrates that the taxpayer is contracting with a Virginia public or private college or university to conduct research and development in Virginia and provides an account of the expenses that have been paid or incurred for contracting, must be attached to the taxpayer's application (Form RDC, Application for Research and Development Expenses Tax Credit) for the research and development expenses tax credit.

A taxpayer with employee(s) performing Virginia qualified research and development activities must provide, upon request, adequate documentation that substantiates the allocation of wages for qualified research and development expenses. Such documentation include, but are not limited to, the name, taxpayer identification number, detailed job description, gross Virginia wages, time cards, internal written documents or other form of record keeping which verify the percentage of time devoted to Virginia qualified research and development activities, and a detailed description of each department or business unit performing qualified research and development and the nature of the research performed.

In addition, a taxpayer may be required to provide proof of purchase, such as an invoice, receipt, cancelled check, bank statement, or credit card statement, upon request.

Application and Filing Requirements

An eligible taxpayer must submit Form RDC, Application for Research and Development Expenses Tax Credit, and any supporting documentation to the Department no later than April 1 in order to claim a tax credit for the taxable year. If the Department determines that the research and development expenses qualify, then the taxpayer will be notified by the Department of the allowable credit amount. Upon receiving notification of the credit amount, the taxpayer must claim the credit on the appropriate Virginia income tax return. The application should be sent to: **Department of Taxation, Attn: Tax Credit Unit, P.O. Box 715, Richmond, VA 23218-0715**, or by fax to **804-367-3021**.

In the event that a taxpayer does not receive notification of the allowable credit amount before their Virginia income tax return is due, the taxpayer may file the return during the extension period or he may file the original return without claiming the credit and then file an amended tax return once notification of the allowable credit amount is received.

All businesses applying for the research and development expenses tax credit must be registered with the Department before submitting Form RDC. If a business is not registered, then Form R-1 must be completed by the business and submitted to the Department.

A pass-through entity must file Form PTE with the Department within 30 days after the credit is granted. All pass-through entities distributing this credit to its owner(s), shareholders, partners or members must give each a Schedule VK-1, Owner's Share of Income and Virginia Modifications and Credits.

Additional Information

These guidelines are available on-line under the Tax Policy Library, Guidance Documents links on the Department's website at www.tax.virginia.gov. For additional information, please contact the Department's Customer Service Section at (804) 367-8037, or us the "Live Chat" feature on the Department's website to communicate online in real time with a Department representative.

Approved:

Craig M. Burns
Tax Commissioner
[INSERT DATE]